MARKET REVIEW: UKRAINE

DEFENCE ECONOMICS

In 2022, the Ukrainian economy shifted to a war footing, while also drawing on the support of international partners, as the nation fought to defend itself.

A PROFOUND IMPACT

On 24 February 2022, Ukraine transitioned overnight to a nation enveloped in full-scale war, defending itself and its people. The economy fell to a low point early in the war as activity stopped amid the emergency. A gradual rebound in economic activity began in the spring of 2022, although systematic attacks on the country's power infrastructure caused additional disruption, especially in the second half of the year.

A large-scale migration ensued, with migration abroad[1] rising to 7.8 million by the year's end and the number of internally displaced people[2] peaking at 8.0 million in early May and receding to 5.9 million by the end of 2022.

The military blockade of the country's seaports, excluding shipments of grain products from Black Sea ports starting from July 2022, led to a substantial fall in output of export-oriented sectors and consequently export revenues. The loss of agricultural crops from territories temporarily occupied by Russia added to the economic strain.

Overall, the Russian Aggression had a massive negative impact on the country's economy. In particular, real GDP fell by 29.1% year-on-year in 2022 after having expanded by 3.4% in 2021.

Meanwhile, nominal GDP fell to US$161 billion[3], down from the historic high of US$200 billion[3] in 2021.

Except for government consumption, the expenditure components of GDP decreased year-on-year, according to State Statistics Service of Ukraine. In particular, exports dropped by 42.4%, gross fixed investments by 34.3%, household consumption by 26.7%, and imports by 18.5%.

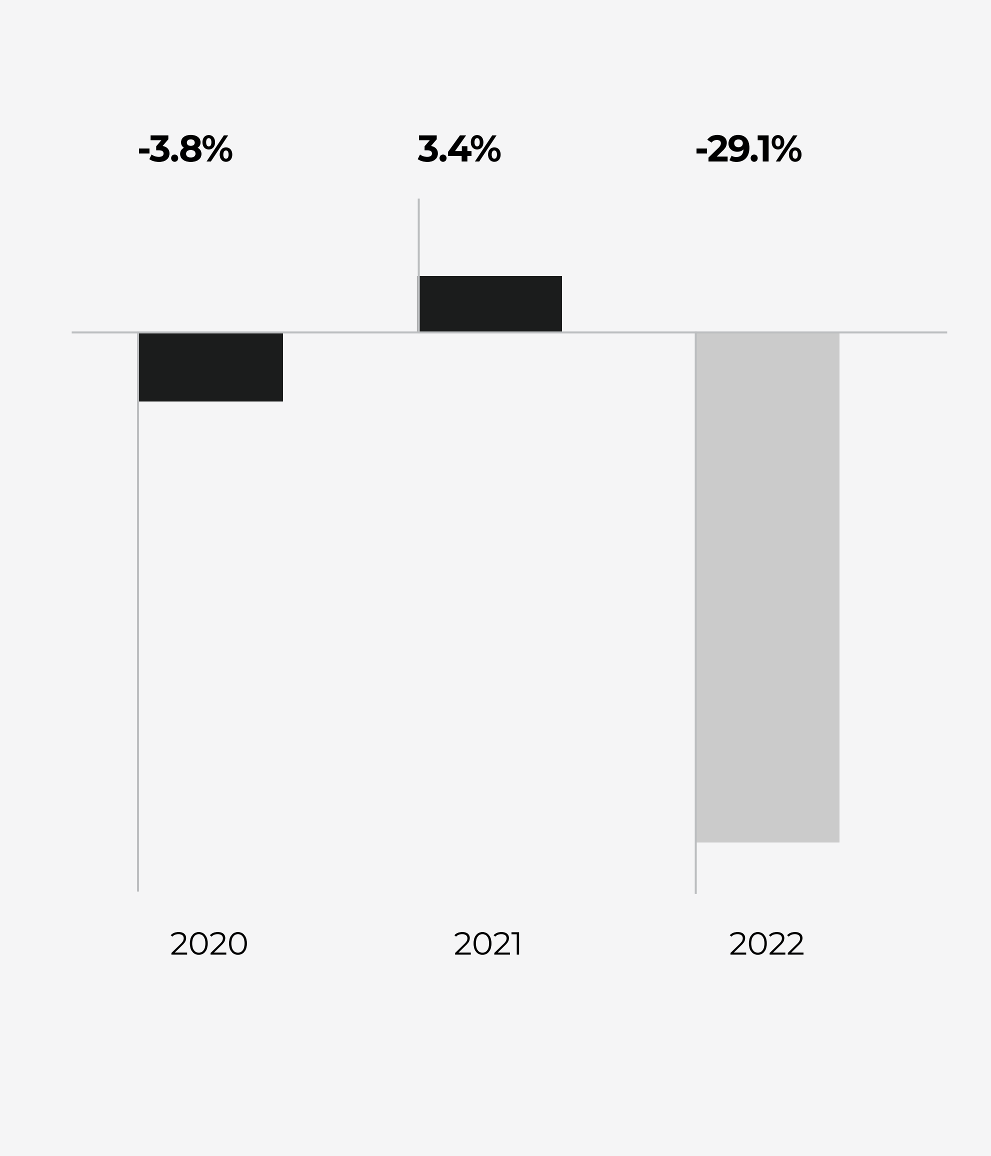
At the same time, general government consumption expanded by 18.0% due to increased spending on defence and security.

Most of the production components of Ukraine's GDP also decreased, including construction – by 67.6%[3], transportation and storage – by 44.3%[3], manufacturing – by 43.1%[3], the mining sector – by 32.2%[3], wholesale and the retail trade – by 30.9%[3], agriculture – by 28.4%[3]. However, public administration jumped by 35.4%[3] to the country's war efforts.

The domestic steel and iron ore sector was hit harder than the country's industrial output on average, which contracted by 36.7%[3] in year-on-year terms. Declines in iron, steel and ferroalloys production of 69.2%[3], coke production and oil refining of 66.6%[3] and mining of metal ores of 61.7%[3] were some of the largest among the industry groups. In contrast, extraction of oil and natural gas decreased by only 8.2%[3] year-on-year and coal extraction slid by 7.7%[3] year-on-year.

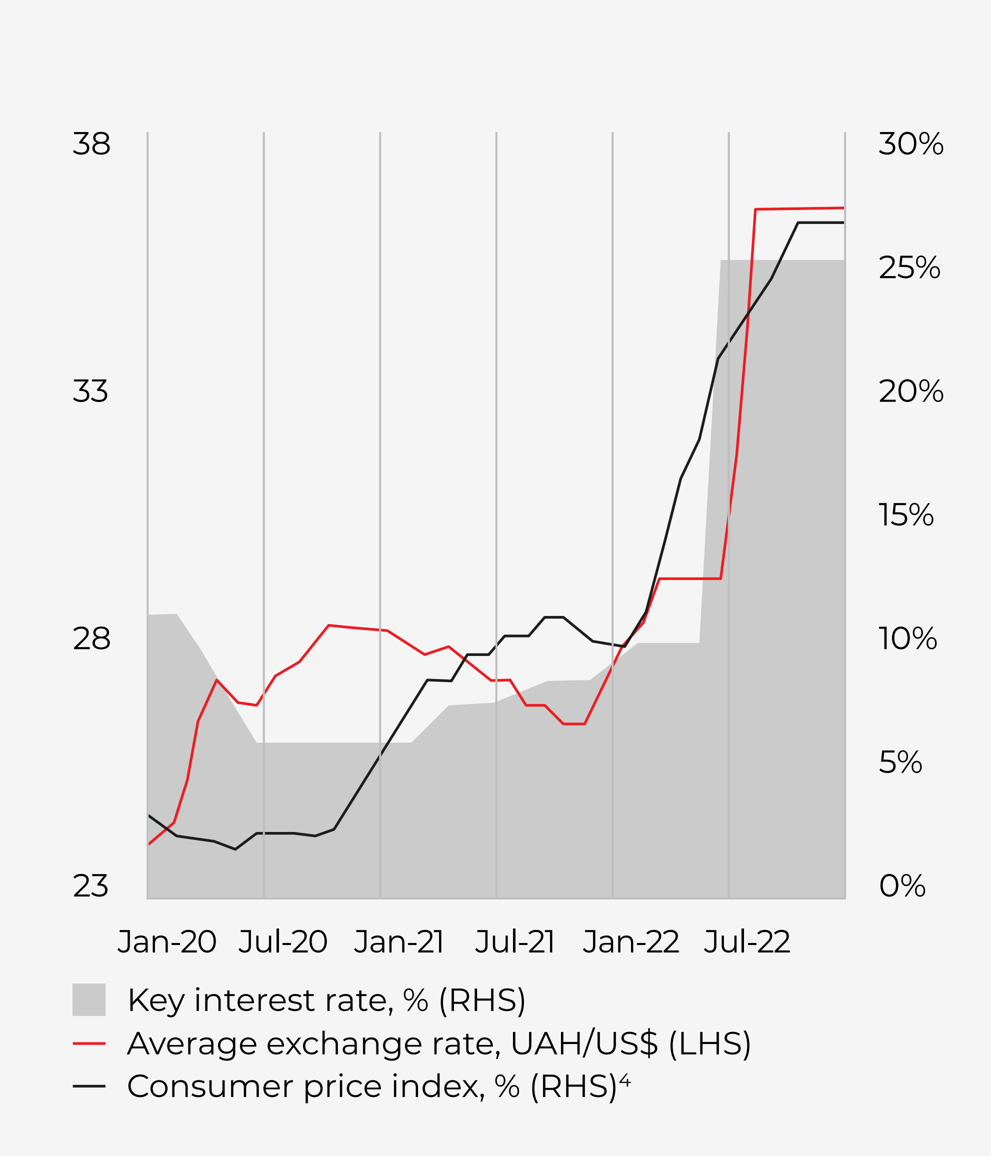
The invasion also exacerbated inflation, driving the annual CPI up from 9.4% in 2021 to 20.2% in 2022. That resulted in a decrease in real incomes and contributed to the decision by the National Bank of Ukraine (NBU) to increase the discount rate. Since June 2022, it has stood at 25%, a nearly seven-year high. Also, the NBU suspended its inflation targeting regime.

Real GDP dynamics



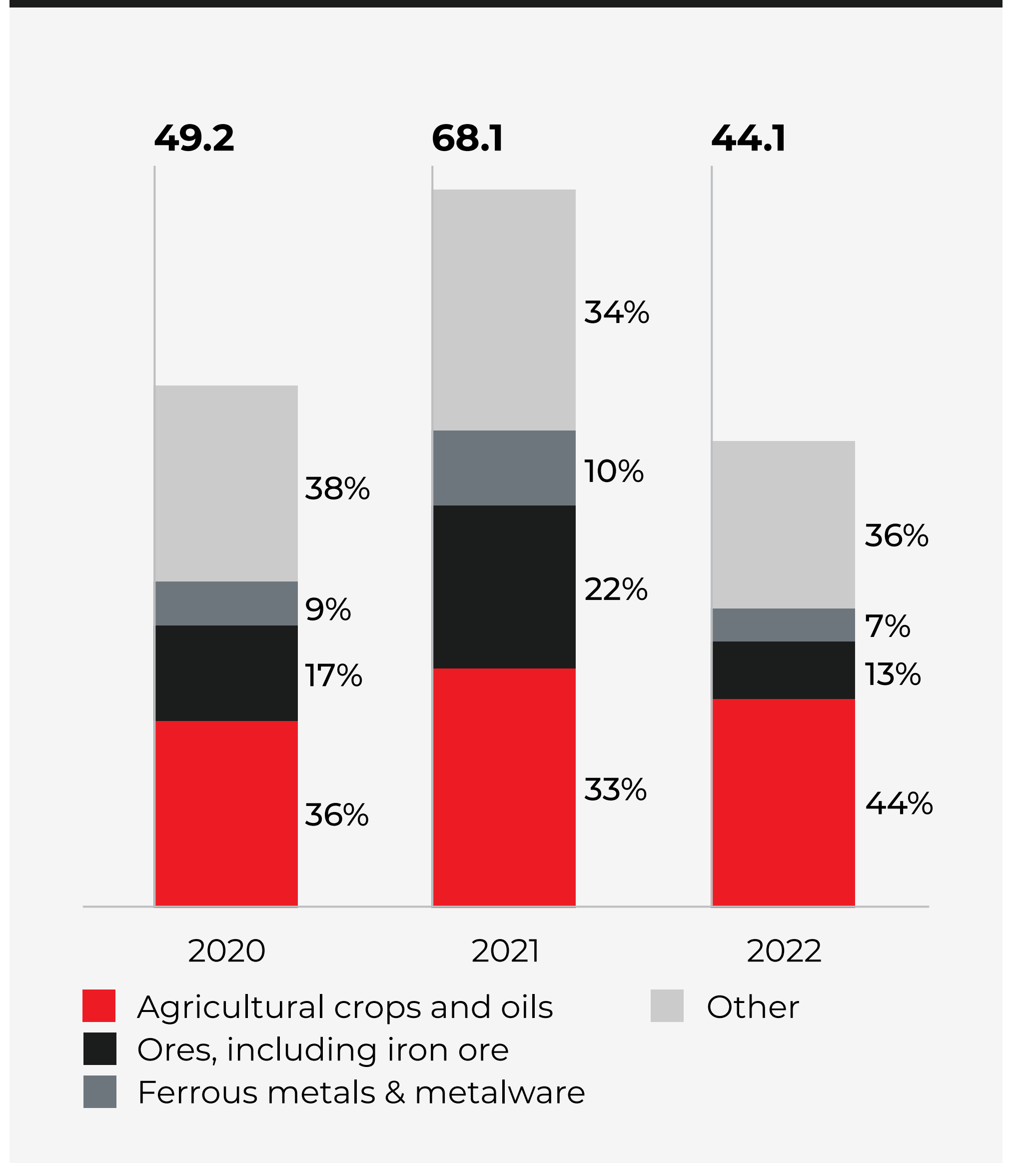
Source: State Statistics Service of Ukraine

Monetary policy



Source: NBU, State Statistics Service of Ukraine

Structure of exports, US$ bn



Source: State Statistics Service of Ukraine

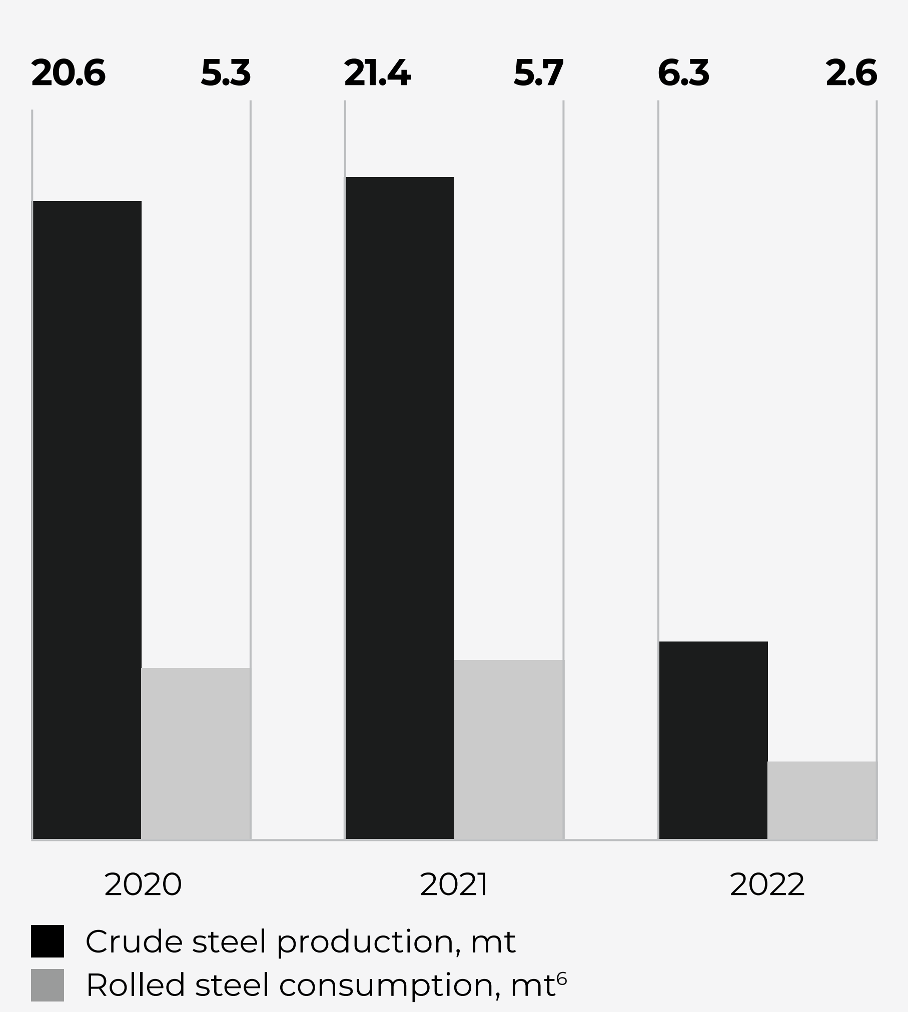
[1] The UN High Commissioner for Refugees.
[2] The UN International Organisation for Migration.
[3] State Statistics Service of Ukraine.
[4] For CPI, the year-on-year change is for the individual monthly periods.

At the same time there were various regulatory changes necessitated by the defence efforts, including tax amendments, restrictions on certain imports and currency exchange controls.

Amid this complex economic landscape, the exchange rate policies of the NBU also underwent significant adjustments. The NBU initially fixed the official exchange rate of the Ukrainian hryvnia against the US dollar at 29.25. Then, in July 2022, it revised this currency peg to 36.57.

Currently, defence and security account for over 50% of total budget expenditures. As a result, the full-scale war has created the largest budget deficit in Ukraine's history at US$28.3 billion[5] in 2022, compared with US$7.3 billion[5] in 2021. Ukraine's international partners have provided substantial monetary support since the beginning of the Russian Aggression, which has helped to cover budget funding needs and the cost of defending the country's sovereignty. The deficit was mostly covered by concessional financing totalling US$32.1 billion[5] from international donors in 2022. This included grants of US$12.0 billion[5] from the US, loans and grants of US$10.7 billion[5] from the EU, as well as loans of US$2.7 billion[5] from the IMF, among other support. They offset the negative effect of a worsening trade balance caused by falling exports amid the naval blockade of the seaports.

Steel industry



Source: WSA, Metal Expert

Against the background of this international support, Ukraine's public debt stood at US$111 billion[5] at the end of 2022 compared with US$98 billion[5] at the end of 2021. The foreign aid also allowed the NBU's international reserves to be US$28.5 billion at the end of 2022, down 7.9% year-on-year and nearly the same as the pre-war level. The substantial decrease in nominal GDP in US dollar terms and the weaker hryvnia brought the ratio of public debt to GDP to 78%[5], compared with 49%[5] in 2021.

All three international rating agencies downgraded their sovereign credit ratings for Ukraine following the Russian invasion. As of 31 December 2022, S&P's rating was 'CCC+', with a 'stable' outlook; Moody's assessment was 'Caa3', with a 'negative' outlook; and Fitch's rating stood at 'CC'.

AN INDUSTRY AT WAR

In 2022, the war deprived Ukraine of the output of two major steelmaking plants that accounted for nearly 40% of pre-war crude steel production. Importantly, the country lost the capacity to make certain goods previously manufactured in Mariupol, including cast slabs, hot-rolled plates and some types of railway and tubular products. Moreover, the national steel industry, traditionally focused on seaborne exports, also had to reorient much of its sales to the neighbouring markets given the limitations of overland routes.

In addition, indiscriminate attacks on civilian infrastructure in the fourth quarter of 2022 led to electricity shortages that hit steelmakers hard, causing average daily output of hot metal, crude steel and rolled steel products to fall by nearly two-thirds after the invasion. As a result, the crude steel production of domestic steelmakers fell by 70.7% to 6.3 million tonnes according to the WSA. This includes Metinvest, which lowered its crude steel output by 69.4% year-on-year to 2.9 million tonnes. Meanwhile, the country's apparent steel consumption (excluding pipes) dropped by 54.9% year-on-year to 2.6 million tonnes, the lowest level for all the years of Ukraine's independence.

In 2022, there were also significant changes in iron ore production amid logistical constraints, reduced local demand and increased production costs. This led to a decline in merchant iron ore product output of 62.1% year-on-year to 29.9 million tonnes, according to the Group's estimates based on Ukrainian Industry Expertise (UEX) data. This includes Metinvest, which decreased its total iron ore concentrate output by 65.8% year-on-year to 10.7 million tonnes.

During the reporting period, Ukrainian mining companies reduced their iron ore exports by 52.2% year-on-year to 21.1 million tonnes. Notably, EU countries have become the main importers of iron ore from Ukraine, displacing China from the top position.

DEVELOPMENTS AFTER THE REPORTING PERIOD

Since the start of 2023, Ukraine has eliminated the power deficit caused by Russia's attacks on energy infrastructure by allowing electricity imports from the EU. This has relieved some of the constraints on Ukraine's industrial sector. Mercifully warm weather also contributed to this effect, relieving one of the bottlenecks holding back Ukraine's economy.

The restoration of adequate power supply has fuelled a rebound in Ukraine's economic activity, driving recovery in steel production, iron ore mining and other key sectors.

Although the impact of Russian missile attacks has waned since early 2023 because of increased air defence support from international partners, they remain a threat and could continue to cause localised power disruptions and infrastructural damage, as well as additional deaths and injuries among innocent Ukrainians. Notably, in March 2023, the IMF Board approved a US$15.6 billion, four-year Extended Fund Facility programme for Ukraine as part of a broader US$115 billion support package, followed by disbursement of the first tranche of US$2.7 billion. This programme has helped Ukraine to secure US$43 billion of external budget financing for 2023 and will serve as an anchor for economic policies and institution building, especially in the fiscal sphere. Importantly, it also helps to offset the financial impact of the national defence effort.

Current expectations regarding Ukraine's economy are cautiously improving based on positive data in some areas. In late May 2023, the IMF upgraded its outlook for Ukraine's 2023 real GDP to growth of 1% to 3%[5] from the previous range of -3% to +1%. Also, as of 1 July 2023, Ukraine's international reserves reached US$39.0 billion, the highest level on record since Ukraine's independence.

Given the circumstances, Ukraine continues to show resilience. The country's vision of victory includes the full liberation of Russian-occupied territories, backed by a strong national tenacity. The continued international support is a vital aspect of Ukraine's ability to repel the Russian invasion and will be crucial for the eventual reconstruction efforts.

[5] Ministry of Finance of Ukraine.
[6] Consumption in Ukraine includes flat, long and certain semi-finished products, but excludes pipes.